Internal Revenue Service

memorandum

CC:TL:Br2
WCWicker

date: JAN 19 1989

to: District Counsel, Manhattan CC:MAN
Attn: Sharon Katz-Pearlman

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [redacted] Merger

This is in reply to your memorandum dated October 20, 1988, in which you request technical advice with respect to the issues stated below.

ISSUES

Whether [redacted]'s tender offer for the stock of [redacted] followed by a merger of [redacted] into a newly formed subsidiary of [redacted], qualifies as a tax free reorganization pursuant to I.R.C. §§ 368(a)(1)(A) and 368(a)(2)(D).

a. Whether the step-transaction doctrine should be applied to integrate the tender offer and subsequent merger.

b. Whether there is sufficient continuity of proprietary interest.

SUMMARY

The facts of the instant case satisfy all three tests for applying the step transaction doctrine. Based on the case law, the most appropriate test to apply here is the end result test. Regardless of which test is invoked, however, the step transaction doctrine should apply to step [redacted]'s tender offer with the subsequent merger of [redacted] into [redacted] [redacted]s wholly owned subsidiary. The tender offer and merger should be integrated into a unified merger transaction.

There is a [redacted]% continuity of interest in the instant case. In John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935), the Supreme Court upheld tax free reorganization treatment where the continuity of interest was only 38%. Accordingly, since it exceeds the continuity percentage that passed muster in John A. Nelson Co., the [redacted]% continuity of interest in the instant case satisfies the continuity of interest requirement for a qualifying reorganization.

Since the step transaction doctrine applies to integrate the tender offer with the merger and since there is sufficient continuity of interest, the integrated transaction (i.e., the tender offer stepped with the merger) qualifies as a tax free reorganization pursuant to I.R.C. §§ 368(a)(1)(A) and 368(a)(2)(D). Accordingly, [redacted] s exchange of its [redacted] stock for [redacted] stock pursuant to the tender offer is accorded nonrecognition treatment by I.R.C. § 354(a)(1). Under section 354(a)(1), the $[redacted] short term capital loss realized by [redacted] on the exchange is not recognized.

FACTS

In the summer of [redacted], [redacted] commenced competing tender offers for shares of [redacted] common stock (the "Shares"). [redacted] initially attempted to negotiate a friendly acquisition of [redacted], but upon failing to do so [redacted] initiated a hostile tender offer on [redacted] for approximately [redacted] of the Shares for $[redacted] per share. [redacted] sought a friendly suitor and, to this end, initiated merger discussions with [redacted]. On [redacted], [redacted] entered into an Agreement of Merger (the "Agreement") with [redacted]. The Agreement provided that (i) [redacted] would make an offer to purchase [redacted]% of the [redacted] stock for cash at not less than $[redacted] per share and the remainder for stock at a ratio of not less than [redacted] shares of [redacted] stock for each [redacted] share; (ii) if certain conditions were satisfied, [redacted] would merge [redacted] into a newly-created subsidiary of [redacted] (the "Merger")[1];

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[1] In addition to the approval of the Merger by the stockholders of [redacted], the obligations of [redacted] and [redacted] to effect the Merger were each subject to: (i) the approval of the proposal to amend the Certificate of Incorporation of [redacted] to increase the authorized number of [redacted] shares and to approve the issuance of [redacted] shares in connection with the acquisition of [redacted]; (ii) the listing on the NYSE, subject to official notice of issuance, of the [redacted] shares to be issued in the Merger; and (iii) the performance by each other of its covenants and the accuracy of its representations and warranties in all material respects. In addition, the obligations of [redacted] were subject to (a) the receipt of any required consent to the Merger under any agreements or contracts, the withholding of which might have a material adverse effect on the business of [redacted] or of [redacted], (b) the absence of governmental action or court order which would have prevented the consummation of the transactions contemplated by the Agreement and (c) holders of not more than

(continued...)

and (iii) [redacted] would be granted an option to purchase an additional [redacted] shares of [redacted] stock directly from [redacted]

[redacted]'s final tender offer, after several modifications, was to purchase up to [redacted]% of [redacted] stock (with a minimum tender requirement of [redacted]%). [redacted] was to purchase [redacted]% of [redacted] stock (and at [redacted]'s election, up to [redacted]%) for $[redacted] per share in cash and the balance for [redacted] common stock at an exchange ratio of [redacted] shares of [redacted] common stock for each such share of [redacted] stock tendered.

[redacted]'s final offer was a cash tender for up to [redacted]% of the Shares (with no minimum tender requirement) for $[redacted] per share. [redacted] in fact purchased approximately [redacted]% of the Shares for cash for an aggregate purchase price of $[redacted].

On [redacted], [redacted] accepted [redacted] shares in exchange for $[redacted] in cash per share. On [redacted], [redacted] purchased for cash and a note [redacted] shares of [redacted] common stock directly from [redacted] pursuant to the option contained in the Agreement. As a consequence, [redacted] gained control of [redacted] and was the winning bidder, with the tendering shareholders losing the right to withdraw absent extraordinary circumstances.

Almost two weeks later, [redacted] stockholders approved a proposal to increase the number of authorized [redacted] shares and the issuance of [redacted] shares in connection with the acquisition. [redacted] then acquired the balance of the tendered shares each in exchange for [redacted] shares of [redacted] common stock. Among the tendered shares were the [redacted] shares owned by [redacted]. On [redacted], the [redacted] shareholders approved the Merger, which was consummated on [redacted] with the remaining [redacted] shareholders receiving stock of [redacted].

For the taxable year ended [redacted], [redacted] claimed a short term capital loss of $[redacted], equal to the difference between (1) [redacted]'s cost in acquiring the [redacted] shares plus acquisition expenses and (2) the fair market value of the [redacted] shares of [redacted] received by [redacted] in the tender

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[1](...continued)
[redacted]% of the [redacted] shares dissenting and demanding appraisal of their [redacted] Shares. The obligations of [redacted] were subject to the absence of a court order which would have prevented the consummation of the transactions contemplated by the Agreement.

offer exchange.[2] The Examining Agent disallowed the claimed loss, stating that the tender offer and merger should be integrated into one transaction and that there existed sufficient continuity of interest to qualify the transaction as a tax free reorganization pursuant to sections 368(a)(1)(A) and 368(a)(2)(D).

[redacted] has taken the position that the reorganization was not tax free, that the step transaction doctrine does not apply and that it is entitled to the claimed loss. [redacted] has executed a restricted 872-A with respect to this issue, pending the determination in the [redacted] case.

DISCUSSION

Issue a.

If [redacted]'s tender offer is not stepped with the subsequent merger of [redacted] into [redacted], [redacted]'s wholly owned subsidiary, then the tax consequences of the tender offer must be determined by examining the tender offer standing alone. By itself, the tender offer would not qualify as any type of reorganization. It would not be a "B" reorganization since it involved the payment of cash for approximately [redacted]% of the stock of [redacted]. It would not be a "C" reorganization since it was a stock acquisition, not an asset acquisition. It would not qualify as any other type of reorganization either. Hence, if the tender offer is not stepped with the merger, the tender offer would consist of a series of taxable stock purchases for cash and taxable stock-for-stock exchanges.

Accordingly, [redacted]'s exchange of its [redacted] stock for [redacted] stock pursuant to the tender offer would be a taxable event, i.e., a recognition event, if the tender offer is not stepped with the merger. Since the exchange would be a recognition event, [redacted] would be entitled to recognize and deduct the $[redacted] short term capital loss it realized on the exchange. If, however, the tender offer is stepped with the merger, the exchange would be considered part of the merger transaction and since the merger qualifies as a reorganization, the exchange would be accorded nonrecognition treatment under I.R.C. § 354(a)(1). Provided the tender offer is stepped with the merger, [redacted] would not be entitled to recognize the $[redacted] loss it realized on the exchange because of the nonrecognition mandated by section 354(a)(1). The tax treatment

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[2] On the exchange date, [redacted] the [redacted] stock was valued at $[redacted] per share, the closing price on the NYSE.

of the [redacted] exchange depends, therefore, on the application of the step transaction doctrine.[3]

The step transaction doctrine is a corollary of the general tax principle that the incidence of taxation depends upon the substance of a transaction rather than its form. See Kuper v. Commissioner, 533 F.2d 152, 155 (5th Cir. 1976). Under the step transaction doctrine, "the tax consequences of an interrelated series of transactions are not to be determined by viewing each of them in isolation but by considering them together as component parts of an overall plan." Crenshaw v. United States, 450 F.2d 472, 475 (5th Cir. 1971). The individual tax significance of each step in the series is irrelevant if the steps when viewed as a whole amount to a single taxable transaction. Id. at 476. "[Taxpayers] cannot compel a court to characterize the transaction solely upon the basis of a concentration on one facet of it when the totality of circumstances determines its tax status." Id. at 477.

There is no universally accepted test as to when and how the step transaction doctrine should be applied to a given set of facts. Courts have applied three alternative tests in deciding whether to invoke the step transaction doctrine in a particular situation. The test most often invoked in connection with the application of the step transaction doctrine is the "end result" test. Under this test, "purportedly separate transactions will be amalgamated into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result." King Enterprises, Inc. v. United States, 418 F.2d 511, 516 (Ct. Cl. 1969). As the Fifth Circuit has noted, when cases involve "a series of transactions designed and executed as parts of a unitary plan to achieve an intended result," the plans will be viewed as a whole "regardless of whether the effect of doing so is imposition of or relief from taxation." Kanawha Gas & Utilities Co. v. Commissioner, 214 F.2d

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[3] It should be noted that if the tender offer and merger are not stepped together, the merger standing alone would qualify as an "A" reorganization. Immediately prior to the merger, [redacted] owned most of the stock of [redacted]. [redacted] was merged into [redacted]. The minority shareholders of [redacted] exchanged their [redacted] stock for [redacted] stock in the merger. [redacted] stock was the sole consideration they received. Hence, the continuity of interest in the merger standing alone would be [redacted]%. Accordingly, the merger standing alone should qualify as a reorganization pursuant to I.R.C. §§ 368(a)(1)(A) and 368(a)(2)(D).

685, 691 (5th Cir. 1954) (emphasis added). Thus, under the end result test, the step transaction doctrine will apply if there is a plan from the outset to achieve an intended result and the transactions in question are component parts of that plan. See generally South Bay Corp. v. Commissioner, 345 F.2d 698 (2d Cir. 1965); Morgan Manufacturing Co. v. Commissioner, 124 F.2d 602 (4th Cir. 1941); Ericsson Screw Machine Products Co. v. Commissioner, 14 T.C. 757 (1950).

A second test for determining whether the step transaction doctrine applies is the "interdependence" test. It focuses on whether "the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series." Redding v. Commissioner, 630 F.2d 1169, 1177 (7th Cir. 1980), cert. denied, 450 U.S. 913 (1981); see also American Bantam Car Co. v. Commissioner, 11 T.C. 397 (1948), affd. 177 F.2d 513 (3d Cir. 1949). The interdependence test concentrates on the relationship between the steps, rather than on their end result. It asks whether the individual steps in a series had independent significance or whether they had meaning only as part of the larger transaction. See Penrod v. Commissioner, 88 T.C. 1415 (1987). If they had meaning only as part of the larger transaction, the step transaction doctrine would apply under the interdependence test.

The third test for determining the applicability of the step transaction doctrine is the "binding commitment" test. The Supreme Court enunciated this standard in Commissioner v. Gordon, 391 U.S. 83, 88 S. Ct. 1517, 20 L.Ed.2d 448 (1968), when it refused to aggregate stock distributions occurring several years apart for tax purposes. The Court commented that "if one transaction is to be characterized as a 'first step' there must be a binding commitment to take the later steps." Id. at 96, 88 S.Ct. at 1524. Thus the "binding commitment" test requires telescoping several steps into one transaction only if a binding commitment existed as to the second step at the time the first step was taken. Subsequent decisions, however, have tended to confine Gordon to its facts. The Seventh Circuit, for example, has concluded that lack of a "binding commitment" should be determinative only in cases involving multi-year transactions. See McDonald's Restaurants v. Commissioner, 688 F.2d 520, 525 (7th Cir. 1982). Similarly, the Court of Claims has read Gordon's "binding commitment" requirement as limited to an interpretation of particular statutory language in section 355 concerning divisive reorganizations. See King Enterprises, 418 F.2d at 517-18. The King Enterprises court reasoned:

> The opinion in Gordon contains not the slightest indication that the Supreme Court intended the binding commitment requirement as the touchstone

> of the step transaction doctrine in tax law .... Clearly, the step transaction doctrine would be a dead letter if restricted to situations where the parties were bound to take certain steps.

Id. at 518 (emphasis in original). See also Levin & Bowen, Taxable and Tax-Free Two-Step Acquisitions and Minority Squeezeouts, 33 Tax L. Rev. 425, 428 n.6 (1978) (Gordon limited to divestiture of control requirement in D reorganization).

The facts of the instant case clearly satisfy the end result test. In response to the hostile takeover attempt by [redacted] sought a friendly suitor and, to this end, initiated merger discussions with [redacted]. From their outset, these discussions contemplated that (1) [redacted] would acquire the entire equity interest in [redacted] and (2) this acquisition would be accomplished in a two-step transaction. The first step would consist of [redacted]s commencing through its wholly owned subsidiary, [redacted], a tender offer for the stock of [redacted]. The second step, which would be taken after the tender offer was consummated, would involve a merger of [redacted] into [redacted]. Both of these steps were embodied in an Agreement executed by [redacted], [redacted] and [redacted] on [redacted]. The Agreement obligated [redacted] and [redacted] to engage in the tender offer and, upon its consummation, if certain conditions were satisfied, to merge [redacted] into [redacted]

The Prospectus for [redacted]s tender offer dated [redacted], specifically noted that "[t]he Offer is the first step of a plan by [redacted] to acquire the entire equity interest in [redacted]."[4] It also stated on page [redacted] that "[t]he purpose of the Offer and Merger is to acquire the entire equity interest in [redacted]." These statements confirm that [redacted]'s plan from the outset was to acquire the entire equity interest in [redacted] and that the tender offer and merger were the component parts of that plan. Accordingly, all the requirements of the end result test are satisfied. We have an overall plan (to acquire all the equity interest in [redacted] and steps designed and executed to accomplish that plan (the tender offer and merger). Moreover, the steps occurred within a [redacted] time frame: from [redacted], the date of the Agreement, to [redacted] the date of the merger. Hence, applying the end result test, the tender offer should be stepped with the merger; that is, it should be considered a part of the merger.

King Enterprises, supra, establishes that it is appropriate to apply the end result test in the context of a merger. In that

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[4] Page [redacted] of the Prospectus.

case, eleven shareholders owned the target corporation. These shareholders sold all of their stock in the target to the acquiring corporation in exchange for cash, promissory notes and stock of the acquiring corporation. The acquiring corporation stock received by the shareholders constituted in excess of 50 percent of the total consideration received. Eight months after the stock sale, the acquiring corporation merged the target into the acquiring corporation.

The Court of Claims in King Enterprises stepped the stock sale with the subsequent merger. It held that the stock sale was an integral part of the merger. It based this holding on its application of the end result test. The court noted that "prior to the acquisition of [the target] stock, the officers of [the acquiring corporation] considered merging its existing subsidiaries into [the acquiring corporation] in order to eliminate some of the general ledgers and extra taxes, and to bring about other savings." 418 F.2d at 518-19. Based on this and other facts, the court concluded that the merger of the target into the acquiring corporation "was the intended result of the transaction in question from the outset, the initial [stock sale] constituting a mere transitory step." 418 F.2d at 519. Accordingly, the court concluded that the stock sale and subsequent merger were steps in a unified transaction qualifying as a Type A reorganization.

There are other cases which have applied the end result test in the context of mergers. One such case is South Bay Corp. v. Commissioner, 345 F.2d 698 (2d Cir. 1965). In that case, an individual purchased most or all of the stock of three companies. He transferred the stock of two of the companies to the third company. The third company then merged the other two companies into the third company. All of these steps were part of the individual's plan, which existed from the outset, to consolidate the assets of the three companies in the third company. Applying the end result test, the Second Circuit stepped all of these transactions and concluded that they amounted to a purchase of assets, not a reorganization. In applying the end result test, the court specifically rejected use of the interdependence test:

> That there must be some species of integrating factor to make it rational to define steps as parts of a single transaction is apparent, but it must be doubted that the degree of integration requisite can be, or ought to be, reduced to any rigid formula of integration or interdependence of steps or can, or ought to, go to the extreme of requiring that each step be devoid of business significance unless united with one or more of the other steps. That would import a rigidity of interpretation appropriate only to

> legislative enactment and inappropriate to the interpretation of a statute....

345 F.2d at 794. This rejection of the interdependence test by the Second Circuit is significant since, if [redacted] files a petition in the Tax Court and loses, its appeal would lie in the Second Circuit. Because its appeal would lie in the Second Circuit, the Tax Court is required under the Golsen rule to apply Second Circuit case law. That case law includes South Bay Corp., the case discussed in this paragraph.

Another case applying the end result test in the context of a stock acquisition followed by a merger is Superior Coach of Florida, Inc. v. Commissioner, 80 T.C. 895 (1983). There, a husband and wife, H and W, owned all the stock of X Co. H and W desired to acquire the business and assets of Y Co. To this end, they purchased all of Y Co.'s stock and one day after the purchase, they caused Y Co. to merge into X Co.

Before the Tax Court, X Co. contended that the merger was a Type A reorganization and therefore that it was entitled to carry over the net operating loss of Y Co. pursuant to I.R.C. § 381(a)(2). The Tax Court rejected X Co's contention. The court stepped H and W's purchase of the Y Co. stock with the subsequent merger and found that the merger lacked sufficient continuity of interest. The historic shareholders of Y Co. did not receive any equity interest in X Co. when they sold their Y Co. stock to H and W. In stepping the sale to H and W with the subsequent merger, the court noted that the merger "was effected by [H and W] as part of an overall plan to acquire the business of [Y Co.]." 80 T.C. at 905. The court further noted that "the ultimate objective of [H and W] was to acquire the assets of [Y Co.] and that the purchase of the [Y Co.] stock and its subsequent liquidation were merely steps in the accomplishment of that objective." Id. Confirming that it was applying the end result test, the court cited King Enterprises.

The second test for determining the applicability of the step transaction doctrine is the interdependence test. The facts of the instant case satisfy this test. [redacted]'s tender offer for the stock of [redacted] was mutually interdependent with the subsequent merger of [redacted] into [redacted], [redacted]'s wholly owned subsidiary. The tender offer and the merger were both required by the Agreement entered into by [redacted], [redacted] and [redacted] on [redacted]. The Agreement provided that [redacted] through [redacted] would make a tender offer for the stock of [redacted] and that following consummation of this offer, [redacted] would be merged, if certain conditions were satisfied, into [redacted]. The Agreement required these two steps (i.e., the tender offer and the merger) because it was [redacted]'s plan to acquire the entire

equity interest in [redacted]. The merger was a necessary part of the plan since [redacted] would need to squeeze out the minority shareholders of [redacted] who did not participate in the tender offer. It was inevitable that there would be such minority shareholders.

The terms of the Agreement establish the interdependence of the tender offer and the merger. Under the Agreement, [redacted] could terminate the tender offer if a federal or state government or governmental authority took any action which would make the consummation of the merger illegal. Similarly, [redacted] could terminate the tender offer if a federal or state court entered an order which would make consummation of the merger illegal. The Agreement provided that the [redacted] shares tendered pursuant to the merger would be converted into cash or [redacted] shares at the same rate as in the tender offer and subject to the same aggregate limitations as to the type of consideration involved.

The overall transaction was structured so that [redacted] would be reasonably assured that a merger would follow consummation of the tender offer. [redacted] conditioned its tender offer purchase obligation on a minimum tender of [redacted] percent of the outstanding stock of [redacted]. The Agreement granted [redacted] an option to purchase [redacted] shares of [redacted] directly from [redacted]. These shares, when issued, would constitute [redacted] percent of the outstanding stock of [redacted]. [redacted] actually exercised this option. These option shares, when combined with the [redacted] percent minimum tender requirement of the tender offer, guaranteed that [redacted] would acquire in excess of [redacted] percent of the stock of [redacted] pursuant to the overall transaction. A simple majority approval of the merger by [redacted] shareholders was all that was required by [redacted] law, the controlling jurisdiction. Hence, [redacted] was assured that consummation of the tender offer (coupled with exercise of the option) would enable it to engage in the merger.

The merger was necessary to the accomplishment of [redacted]'s plan of acquiring the entire equity interest in [redacted]. The tender offer alone would not have accomplished the plan. The legal relationships created by the tender offer would have been fruitless, standing alone, insofar as accomplishing the plan was concerned. The Agreement provided all the necessary ingredients for accomplishing the plan. It provided for the tender offer, the grant of an option and the merger. These three transactional items were interdependent.

A case applying the interdependence test in the context of a merger is Kass v. Commissioner, 60 T.C. 218 (1973). In Kass, the acquiring corporation engaged in a cash tender offer for the stock of the target. It purchased more than 80 percent of the

target's stock pursuant to the offer. One month after the offer took place, the target was merged into the acquiring corporation. The taxpayer in Kass was a minority shareholder of the target who, pursuant to the merger, received stock of the acquiring corporation in exchange for her appreciated target stock. She reported no gain on this exchange, contending that the merger was a Type A reorganization and hence that her receipt of the acquiring corporation stock was tax free under I.R.C. § 354(a)(1).

The court rejected the taxpayer's position. It stepped the cash tender offer with the merger and concluded that the merger lacked sufficient continuity of interest. Stepping the two transactions together, the court viewed the historic shareholders of the target as being the pre-tender offer shareholders of the target. These shareholders sold more than 80 percent of the target's stock to the acquiring corporation for cash. Hence, the continuity of interest in the merger was less than 20 percent. Such a low continuity was not sufficient, the court held, to satisfy the continuity of interest test.

The court described the cash tender offer and the merger as "interdependent events." This suggests that the court applied the interdependence test. In its recital of the facts, the court focused on the purpose of the individuals who incorporated the acquiring corporation: "Their purpose in forming [the acquiring corporation] was to gain control over [the target's] racetrack business.... Control was to be gained by establishing [the acquiring corporation] and then by (1) having [the acquiring corporation] purchase at least 80 percent of the stock of [the target] and (2) subsequently merging [the target] into [the acquiring corporation]." 60 T.C. at 219-20. The court further noted that the cash tender offer and the merger were part of "an integrated plan to obtain control over [the target's] business. The plan called for, first, the purchase of stock and, second, the subsidiary-into-parent merger." (emphasis added) Id. at 223.

The third test for determining the applicability of the step transaction doctrine is the binding commitment test. This test provides that steps are to be amalgamated into a single transaction only if there exists at the time the first step is undertaken a binding commitment to engage in the later steps.

We think this test is satisfied in the instant case. The source of the binding commitment is the Agreement entered into by [redacted], [redacted] and [redacted] on [redacted]. The Agreement required [redacted] to merge [redacted] into [redacted] following consummation of the tender offer. Admittedly, [redacted]'s obligation to effect the merger was subject to numerous

conditions.[5] These conditions did not, however, vest [redacted] with unbridled discretion to "walk away" from the merger. [redacted] could forego the merger only if certain specific, well defined events occurred or did not occur. These conditions to which [redacted]'s obligation was subject were reasonable and standard in the merger context. [redacted]'s obligation to engage in the merger was a fixed obligation subject to defeasance by these conditions. [redacted] was bound by its obligation unless one of the conditions occurred.

In light of McDonald's Restaurants of Illinois, Inc. v. Commissioner, 688 F.2d 520 (7th Cir. 1982), rev'g 76 T.C. 972 (1981), we believe that [redacted]'s conditional obligation to effectuate the merger satisfied the binding commitment test, i.e., that the obligation constituted a binding commitment for purposes of the test. In McDonald's Restaurants, a number of corporations were merged into an acquiring corporation in a transaction in which the three shareholders of the acquired companies received unregistered voting stock of the acquiring company. The three shareholders of the acquired corporations had sought an all-for-cash exchange, but the acquiring company was only willing to issue stock because it wanted the acquisitions to qualify as a pooling of interests under the then-prevailing accounting rules. The acquiring company, however, agreed to permit the selling shareholders to include the shares they received in a registration and underwriting which was to take place approximately two months after the merger or in any other registration and underwriting which it might undertake for five years thereafter. While the expected registration was cancelled due to a drop in the price of the stock of the acquiring corporation, a registration and underwriting pursuant to which the three shareholders sold virtually all of the stock they had received in the merger did take place approximately six months after the merger.

The acquiring company, which was the taxpayer in McDonald's Restaurants, took the position that the continuity-of-interest requirement for reorganization treatment was not satisfied and that it was accordingly entitled to a stepped-up basis for the assets acquired by it in the merger. The Revenue Service refused to allow a stepped-up basis, arguing that the merger was a valid "A" reorganization notwithstanding the subsequent stock sale.

The Tax Court took the position that continuity of interest is violated only by post-acquisition dispositions that are related to the reorganization exchange. Accordingly, it

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[5] These conditions are set forth in footnote 1 of this memorandum.

considered whether the merger and the sale should be stepped together for this purpose. Applying the "mutual interdependence" variant of the step-transaction doctrine, the court concluded that the merger and the sale were in fact independent transactions because the shareholders of the acquired corporations were not obligated to sell the stock received by them, the merger was not contingent on the subsequent sale, and the stock was subject to all the risks of the market. It concluded that the merger and the sale should not be stepped together, that the continuity-of-interest requirement was therefore not violated, and that a basis step-up was consequently not permissible.

On appeal, the Court of Appeals for the Seventh Circuit reversed the Tax Court and held that no reorganization had taken place. The taxpayer was therefore entitled to a cost basis in the assets acquired, just as if the acquisition had been for cash. The court reasoned that the merger and subsequent sale should be treated as a single integrated transaction regardless of which variant of the step-transaction doctrine properly was applicable. It found that the "mutual interdependence" test was satisfied because the merger would not have taken place without the "guarantees of saleability" provided by the registration rights obtained by the shareholders of the acquired companies. 688 F.2d at 524. The "spirit, if not the letter" of the binding commitment test was also satisfied, the court stated, because the registration and underwriting provisions in the agreement between the parties made it "extremely likely" that a sale of the shares would take place promptly. Id. at 525. Accordingly, the court held that the merger failed to satisfy the continuity-of-interest requirement for reorganization treatment.

The Court of Appeals acknowledged, when it applied the binding commitment test, that the shareholders of the acquired companies were not contractually obligated to sell the stock they received in the merger. This absence of a contractual obligation did not preclude satisfaction of the binding commitment test for two reasons, the court stated. First, the binding commitment test was originally formulated as a test for stepping together transactions that spanned several years. Here, the transactions (the merger and the sale) were separated by only six months. Given this relatively short interval between the two steps, it was appropriate to apply a relaxed, or less stringent, version of the binding commitment test. Second, as previously stated, the registration and underwriting provisions in the agreement between the parties made it "extremely likely" that a sale of the stock received in the merger would take place promptly. On the basis of these two factors, the court concluded that the binding commitment test was satisfied.

The facts in the instant case satisfy the relaxed binding commitment standard adopted by the Seventh Circuit in McDonald's Restaurants. In fact, the facts here present a stronger case for satisfying the binding commitment test than did the facts in McDonald's Restaurants. Here, unlike the situation in McDonald's Restaurants, there was a contractual obligation to engage in the second step, i.e., the Agreement obligated [redacted] to effect the [redacted] merger following consummation of the tender offer. Furthermore, the time interval between the steps here was only [redacted] months whereas in McDonald's Restaurants it was six months. Finally, the Agreement, the stock option granted to [redacted] in the Agreement and the structure of the tender offer all made it "extremely likely" (in the words of McDonald's Restaurants) that consummation of the tender offer would be followed by a merger of [redacted] into [redacted]. For all of these reasons, we conclude that [redacted]'s conditional obligation to effect the merger of [redacted] and [redacted] satisfied the binding commitment test.

Accordingly, we have determined that the facts of the instant case satisfy all three tests for determining the applicability of the step transaction doctrine. The test most easily satisfied is the end result test. This is the test the Service should adopt and urge as the most appropriate one to apply. If [redacted] chooses the Claims Court as its forum, the Service should cite King Enterprises as establishing the appropriateness of the end result test. If [redacted] chooses the Tax Court or a district court, the Service should cite South Bay Corp. as establishing the propriety of applying the end result test. Regardless of which test is applied by the forum chosen, however, we think that the result will be the same. Under all three tests, the step transaction doctrine should apply to step [redacted]'s tender offer with the subsequent merger of [redacted] into [redacted]. The tender offer should be treated as an integral part of the merger.

Notwithstanding our conclusions, [redacted] contends that Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988), establishes the inappropriateness of using the step transaction doctrine in the instant case. In Esmark, pursuant to a written agreement with Esmark, Inc. ("Esmark"), Mobil launched a public tender offer to acquire in excess of 50% of Esmark's stock for cash. The express purpose of the tender offer was to permit Mobil, pursuant to the same agreement, to exchange the Esmark shares acquired by Mobil for Esmark's Transocean energy business on the day that Mobil completed its tender offer. This was accomplished by Esmark's distribution of the stock of Transocean's parent corporation, Vickers, in redemption of Mobil's newly-acquired Esmark shares. The second step redemption satisfied the literal language of I.R.C. § 311(d)(2)(B), which allowed nonrecognition, in certain

circumstances, on the distribution of stock of a subsidiary to redeem the stock of its parent corporation.

The Service argued, inter alia, that, because of the contractual obligation of Mobil to exchange the shares it acquired in its tender offer for Transocean, the step transaction doctrine should apply so as to disregard Mobil's ownership of the shares, i.e., Esmark should be viewed as having sold its energy business to Mobil and redeemed its stock for cash. The Tax Court acknowledged that the tender offer was part of an overall plan, but nevertheless refused to apply the step transaction doctrine, stating:

> Respondent proposes to recharacterize the tender offer/redemption as a sale of the Vickers shares to Mobil followed by a self-tender. This recharacterization does not simply combine steps; it invents new ones. Courts have refused to apply the step-transaction doctrine in this manner.

90 T.C. at 196.

In the instant case, we are not inventing new steps. Our proposed application of the step transaction doctrine does not result in the creation of fictional events. We are simply subsuming one actual event under another. We are saying that the tender offer exchanges should be considered part of the merger exchanges. We are combining the tender offer with the merger to create one unified merger transaction. We are not recharacterizing the tender offer and merger into events that never took place. Because, in our application of the step transaction doctrine, we are merely subsuming one actual event under another, the instant case is readily distinguishable from Esmark. The court's quoted rationale for denying step transaction treatment in Esmark is not applicable to the instant case.

Issue b.

In a February 11, 1985 memorandum addressed to the Chief Counsel, Associate Chief Counsel (Technical) and Assistant Commissioner (Examination), we determined that there was a [redacted] continuity of interest in the [redacted] merger transaction and that this percentage continuity satisfied the continuity of interest requirement for a qualifying reorganization. Our determination that the continuity of interest requirement was satisfied was based on three conclusions we set forth in that memorandum. Those conclusions were:

(1) The [redacted] shares received in exchange for [redacted] stock

previously acquired by [redacted]'s competitors for [redacted] count toward meeting continuity, because the acquisitions of [redacted] stock by [redacted]'s competitors were not in furtherance of [redacted]'s acquisition plan. Thus, [redacted] should be treated as a historic shareholder of [redacted] in determining the continuity of interest in the [redacted] merger transaction.

(2) The authorized but unissued shares of [redacted] stock purchased by [redacted] pursuant to the option are not considered to be outstanding stock of [redacted] for continuity purposes, because those shares are irrelevant to the determination of the degree of continued equity participation by the former shareholders of [redacted].

(3) Although for private letter ruling purposes the Service requires 50% (by value) continued equity participation, the Supreme Court has upheld tax-free reorganization treatment in a case with 38% continuity of interest. That case was John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935).

In addition to being based on conclusions (1) and (2) stated above, the determination in the previous memorandum that there was a [redacted]% continuity of interest in the [redacted] merger transaction was also based on the assumption that [redacted]'s tender offer should be stepped with the merger. We have demonstrated in this memorandum that that assumption is correct. We reaffirm here the three conclusions stated above and the reasons for those conclusions as stated in the previous memorandum. We continue to adhere to the analysis set forth in that memorandum. There is, in short, a [redacted]% continuity of interest in the instant case and that continuity satisfies the continuity of interest requirement for a qualifying reorganization. See John A. Nelson Co., supra, and the analysis set forth in the previous memorandum.[6]

CONCLUSION

The step transaction doctrine applies to step [redacted]'s tender offer with the merger of [redacted] into [redacted]. The tender offer and merger should be integrated into a single, unified merger transaction. The [redacted]% continuity of interest in the instant case satisfies the continuity of interest requirement for a qualifying reorganization. Based on these conclusions, the integrated transaction (i.e., the tender offer stepped with the merger) qualifies as a reorganization pursuant to I.R.C. §§ 368(a)(1)(A) and 368(a)(2)(D).

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[6] A copy of the previous memorandum is appended hereto.

We are in the process of coordinating our views, as presented herein, with Technical. Once this coordination is completed, it may be necessary to modify or amplify our views in a supplemental memorandum. If a supplemental memorandum proves necessary, we will immediately alert you to the fact that it is forthcoming. If the coordination indicates that no modification or amplification of our views is necessary, we will notify you of this fact, too. At the present time, based on our conversations to date with Technical, we do not anticipate that there will be any modification of our views.

MARLENE GROSS

By: Alfred C. Bishop, Jr.
ALFRED C. BISHOP, JR.
Chief, Branch No. 2
Tax Litigation Division

Attachment:
As stated.

Internal Revenue Service

memorandum

date:

to: Chief Counsel
Associate Chief Counsel (Technical)
Assistant Commissioner (Examination)

from: Director, Tax Litigation Division
Director, Interpretative Division
Chief, Reorganization Branch, Corporation Tax Division

subject: [redacted] Merger of [redacted], into [redacted]

FACTS

In [redacted], [redacted], merged into [redacted] (Newco), a wholly owned subsidiary of [redacted], in a transaction intended to qualify as a reorganization under sections 368(a)(1)(A) and (a)(2)(D) of the Internal Revenue Code (forward triangular merger). According to the information supplied by the I.R.S. field office, [redacted] acquired approximately [redacted] shares ([redacted] percent) of [redacted] stock in exchange for cash and approximately [redacted] shares ([redacted] percent) in exchange for its stock. Assuming the [redacted] stock issued in the transaction is valued on the date of the merger, the field agent determined the fair market value of the consideration received by former [redacted] shareholders to be approximately [redacted]% stock and [redacted]% cash.

In [redacted], approximately one month prior to the merger, [redacted] exercised an option to purchase [redacted] authorized but unissued shares of [redacted] stock for cash and notes. As a result of such exercise, [redacted]s outstanding stock increased from approximately [redacted] to [redacted] shares. The option shares acquired by [redacted] constituted approximately [redacted] percent of the then outstanding [redacted] stock. These shares and the [redacted] notes issued as partial consideration therefor were subsequently cancelled in the merger transaction. If the acquisition of the option shares is considered part of the subsequent reorganization, this would change the exchange ratio, set forth above, to approximately [redacted] percent stock and [redacted] percent cash. In terms of fair market value, this would change the exchange ratio to approximately [redacted]% stock and [redacted]% cash if valued on the date of the merger.

During the same time period, several other parties were also attempting to obtain control of [redacted]. [redacted], succeeded in acquiring approximately [redacted] percent of the outstanding [redacted] stock (not counting the option shares). In addition, at least [redacted] other competitors made public tender offers to acquire substantial amounts of [redacted] stock. According to information provided by [redacted], [redacted] exchanged all of its newly acquired [redacted] stock for [redacted] stock in the transaction. If the [redacted] stock received by [redacted] is not counted toward

meeting continuity, this would change the exchange ratio to approximately [redacted] stock and [redacted] cash (not counting the option shares) if valued on the date of the merger.

ISSUES

The overriding issue of this case is whether there was a continuity of proprietary interest as required by sections 1.368-1(b) and 2(a) of the Income Tax Regulations, so that the merger of [redacted] into Newco qualified as a reorganization under sections 368(a)(1)(A) and (a)(2)(D) of the Code. This memorandum will discuss three underlying issues which must be resolved in order to determine whether the requisite continuity of interest is present in this case.

(1) Do the shares of [redacted] stock received in exchange for [redacted] stock previously acquired for cash by parties such as [redacted], who had competed with [redacted] for the acquisition of [redacted], count toward meeting the continuity of interest requirement?

(2) Are the authorized but unissued shares of [redacted] stock purchased by [redacted] from [redacted] as part of its plan to acquire [redacted] considered to be outstanding stock of [redacted] for purposes of the continuity of interest requirement?

(3) What continuity of interest percentage is required for the merger to qualify as a reorganization under sections 368(a)(1)(A) and (a)(2)(D) of the Code?

CONCLUSIONS

(1) The [redacted] shares received in exchange for [redacted] stock previously acquired by [redacted]'s competitors for [redacted] count toward meeting continuity, because the acquisitions of [redacted] stock by [redacted]'s competitors were not in furtherance of [redacted]'s acquisition plan.

(2) The authorized but unissued shares of [redacted] stock purchased by [redacted] are not considered to be outstanding stock of [redacted] for continuity purposes, because those shares are irrelevant to the determination of the degree of continued equity participation by the former shareholders of [redacted].

(3) Although for private letter ruling purposes the Service requires 50% (by value) continued equity participation, the Supreme Court has upheld tax-free reorganization treatment in a case with 38% continuity of interest.

Based on our resolution of issues (1) and (2), and using the calculations of the field agent, there is approximately [redacted] continuity of interest in this case. This is comfortably above the 38% figure considered adequate by the Supreme Court, and within striking distance of the 50% test used by the Service for rulings purposes. Therefore, we conclude that there is sufficient continuity of proprietary interest in this case to satisfy the requirements for a qualifying reorganization.

LAW AND ANALYSIS

Issue(1)

For a corporate merger to qualify as a reorganization under section 368 of the Code, there must be a* continuity of proprietary interest. Sections 1.368-1(b) and 2(a) of the regulations provide that the major distinction between those transactions which constitute sales of property and those constituting a mere readjustment of corporate structure is the presence of a continuing equity interest on the part of shareholders of the target corporation prior to the transaction. See also Le Tulle v. Scofield, 308 U.S. 415 (1940) and Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935). The requirement that the former shareholders of the target retain a continuing equity interest in the acquiring corporation is a judicially created concept designed to confine the tax-free reorganization provisions to their proper function. See Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2nd Cir. 1932), cert. denied, 288 U.S. 599 (1933); West Side Federal Savings & Loan Assn. v. United States, 494 F.2d 404, 406 (6th Cir. 1974).

The continuity of interest rule was amplified in Yoc Heating Corp. v. Commissioner, 61 T.C. 168 (1973), which held that target corporation stock purchased from the target shareholders for cash

and notes as an integral part of a plan to acquire the target's assets does not apply toward satisfying the continuity of interest requirement. In Yoc Heating, the purchaser wished to acquire all of the assets of the target, and to use them in a business conducted in a newly formed subsidiary. After some negotiation, the target informed the purchaser that because of opposition from minority shareholders, the transaction could not be consummated as an asset sale. Instead, shareholders of the target owning approximately 85 percent of its stock offered to sell their stock to the purchaser. Because the purchaser had been advised that a step-up in basis could be obtained through a purchase of the target stock, as an alternative to a direct asset acquisition, the purchaser acquired the 85 percent block of the target stock for cash and notes. After the stock purchase, the target transferred all its assets and liabilities to a newly formed subsidiary of the purchaser and the target was liquidated.

The taxpayer in Yoc Heating, the subsidiary, argued that it took the assets of the target with a stepped-up basis. The Commissioner contended that the acquisition of the target's assets by the subsidiary was a tax-free reorganization, therefore, requiring the subsidiary to take the target assets with a carryover basis.

In holding that the transaction lacked the requisite continuity of interest to qualify as a tax-free reorganization, the Tax Court focused on the intent of the acquiring corporation, and the fact that each step of its plan was aimed at procuring a step-up in basis. Applying the step-transaction doctrine, the court treated the acquisition of the target stock and the acquisition of the target assets as one transaction, and concluded that sufficient continuity of interest was not present since roughly 85 percent of the target stock had been acquired for cash and notes. See also Security Industrial Insurance Co. v. United States, 702 F.2d 1234 (5th Cir. 1983); King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969); Superior Coach v. Commissioner, 80 T.C. 895 (1983); Estate of McWhorter v. Commissioner, 69 T.C. 650 (1978), aff'd in an unpublished opinion, 590 F.2d 340 (8th Cir. 1978); Kass v. Commissioner, 60 T.C. 218 (1973), aff'd without opinion, 491 F.2d 749 (3d Cir. 1974) (all illustrating application of the step-transaction doctrine in determining continuity of interest).

The most commonly invoked standard in determining whether to apply the step-transaction doctrine is the "end result" test. Under this test, "purportedly separate transactions will be amalgamated into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the

ultimate result." King Enterprises, 418 F.2d at 516 (footnote omitted) (quoting Herwitz, Business Planning 804 (1966)). "As the Fifth Circuit has noted, when cases involve 'a series of transactions designed and executed as parts of a unitary plan to achieve an intended result,' the plans will be viewed as a whole 'regardless of whether the effect of doing so is imposition of or relief from taxation.'" Security Industrial, 702 F.2d at 1244 (emphasis added by Security Industrial) (quoting Kanawah Gas & Utilities Co. v. Commissioner, 214 F.2d 685, 691 (5th Cir. 1954)). A second test used in applying the step-transaction doctrine is the "interdependence" test, which focuses on whether "'the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.'" Redding v. Commissioner, 630 F.2d 1169, 1177 (7th Cir. 1980), cert. denied, 450 U.S. 913 (1981) (quoting R. Paul & P. Zimet, Selected Studies in Federal Taxation 200, 254 (2d Series 1938)). The third test for determining whether the step-transaction doctrine applies is the "binding commitment" test. This standard, enunciated in Commissioner v. Gordon, 391 U.S. 83, 96 (1968), restricts the application of the step-transaction doctrine to those instances in which a binding commitment existed as to the second step at the time the first step was taken. Basically, then, transactions must be meaningful, independent acts to avoid integration under the step-transaction doctrine. See generally McDonalds Restaurants, Inc. v. Commissioner, 688

F.2d 520, 524-25 (7th Cir. 1982); B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶14.51 (4th ed. 1979), both discussing all three tests for application of the step-transaction doctrine.

Analysis of the facts at issue under all three of the above tests leads to the conclusion that the step-transaction doctrine should not be used to integrate the [redacted] stock purchases by parties competing with [redacted] with the subsequent merger of [redacted] into Newco. It is clear from the public record that [redacted] was the target of several competing corporations, all of which desired to obtain control of [redacted] through the acquisition of a majority interest in its stock. Far from being component parts of a single transaction intended to reach the ultimate result of the acquisition of [redacted] by [redacted], as required by the "end result" test, these purchases by [redacted]'s competitors actually were adverse to the interests of [redacted]. For the same reason, the stock purchases cannot constitute interdependent steps of one transaction as contemplated by the "interdependence" test. Moreover, because [redacted]'s competitors were seeking to acquire [redacted] themselves, they certainly were not obligated to effectuate [redacted]'s acquisition of [redacted], so the "binding commitment" test is also not applicable. Thus, we believe it would be improper to apply the step-transaction doctrine to link these purchases with [redacted]'s acquisition of [redacted].

Limiting the application of the step-transaction doctrine to those instances in which purchases of target stock are part of the acquiring corporation's acquisition plan is consistent with Yoc Heating and the other cases cited above. For example, in Kass, the step-transaction doctrine was applied to integrate the purchase of target stock by the acquiring corporation with the subsequent merger of the target into the acquiring corporation. The Tax Court found that the target stock was acquired as part of an integrated plan to obtain control of the target's business and, thus, the transaction lacked a sufficient degree of continuity of interest to be accorded tax-free status. A similar conclusion was reached in Superior Coach, in which a majority shareholder of the acquiring corporation purchased the target stock as part of the acquisition plan.

There are two arguments for rejection of the above position. First, it might be argued that adoption of the above position is inconsistent with McDonald's Restaurants and Heintz v. Commissioner, 25 T.C. 132 (1955), nonacq., 1958-1 C.B. 7. In those cases, post-merger sales to third parties of the acquiring corporation's stock received by former target shareholders were considered in making the continuity of interest determination. However, those cases applied the step-transaction doctrine in determining whether to count the postmerger sales, and denied tax-free treatment only because the courts found that the sales were an integral part of

the acquiring corporation's acquisition plan. Thus, those cases are consistent with our position in this case.

The second argument against our position is that it conflicts with the seemingly more temporal approach currently used by some courts. Under this temporal approach, the decision of whether premerger sales of target stock are to be considered part of the subsequent merger of the target into the acquiring corporation is made by looking at the proximity of such sales to the subsequent merger. See, e.g., Security Industrial, 702 F.2d at 1243, which states: "[t]he continuity or interest issue here is basically one of timing: at what stage in these transactions should the shareholders' proprietary interests be measured?"

We believe that reliance on a purely temporal approach is improper. While stock purchases occurring shortly before a merger are inherently suspect and should be given close scrutiny, we do not believe that time is the only factor to be used in determining whether such purchases should count against continuity of interest. Indeed, we believe that a close reading of Yoc Heating and Kass, the two cases in which this temporal approach finds its roots, reveals that both courts actually applied the step-transaction doctrine in a more functional manner, so that time was just one factor used in determining whether the stock purchases were an integral part of the overall transaction. See, e.g., Kass, 60 T.C. at 222-23 (footnotes and citations omitted) (emphasis added), which states:

> Reorganization treatment is appropriate when the parent's stock ownership in the subsidiary was not acquired as a step in a plan to acquire assets of the subsidiary: the parent's stockholding can be counted as contributing to continuity-of-interest, so that since such holding represented more than 80 percent of the stock of the subsidiary [in Kass], the continuity-of-interest test would be met. Reorganization treatment is inappropriate when the parent's stock ownership in the subsidiary was purchased as the first step in a plan to acquire the subsidiary's assets. . . . The parent's stockholding could not be counted towards continuity-of-interest, so in the last example there would be a continuity-of-interest of less than 20 percent. . . . In short, where the parent's stock interest is 'old and cold,' it may contribute to continuity-of-interest. Where the parent's interest is not 'old and cold,' the sale of shares by the majority of shareholders actually detracts from continuity-of-interest.

Kass was the first case to use the term "old and cold", and although the term has a temporal ring, the above-quoted language demonstrates that Kass ascribed a functional rather than a temporal meaning to the term. Subsequent cases have adopted the term "old and cold shareholders" (or "historic shareholders") as a convenient label to describe the shareholders whose proprietary interests in the continuing enterprise must be preserved for there to be a qualifying reorganization, but usually without explaining the term. These cases have emphasized the element of time in their application of the step-transaction doctrine because they involved stock purchases made by, or on behalf of, the acquiring corporation. However, in cases like the present one, involving target stock

purchases by third parties, the timing of the purchases is less significant because purchases by third parties are unlikely to be in furtherance of the acquiring corporation's acquisition plan, even though they may occur shortly before the merger. Essentially, time is only one of the factors used to determine whether stock purchases are an integral part of the acquisition plan, and is not, in and of itself, determinative.

Issue (2)

We do not believe that sales of authorized but unissued shares of [redacted] stock to [redacted] as part of [redacted]'s plan to acquire [redacted] should be counted in determining whether the continuity of proprietary interest requirement is satisfied. Our conclusion is based upon the purpose of the continuity of interest requirement and the fact that we can find no authority or reasoning to support a contrary position.

As stated in section 1.368-1(b) of the regulations, requisite for tax-free treatment is "a continuity of interest therein on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization." Target stock newly issued to the acquiring corporation as part of its acquisition plan should not be taken into account in applying a standard designed to insure continued equity ownership by shareholders of the target prior to the transaction.

In addition, to conclude otherwise is to invite manipulation

of the continuity of interest doctrine and avoidance of its purpose. If newly issued target stock acquired by the acquiring corporation were taken into account for purposes of the continuity test, such stock could be used to cause the acquisition to either fail or meet the test, depending on the number of shares issued and the nature of the consideration received by the target for its issuance. Issuance of such additional shares of target stock increases the total value of the target stock outstanding, and thus, if considered for continuity purposes, would dilute the importance of the nature of the consideration received by the former shareholders of the target. In situations like the present case, where the newly issued target stock is acquired for nonqualified consideration (cash), the amount of nonqualified consideration that could be received for the remaining target stock would be reduced. However, if the newly issued target stock were acquired instead for qualified consideration (stock), the amount of nonqualified consideration that could be received for the remaining target stock would be increased, thereby increasing the number of former shareholders of the target who could be cashed out without jeopardizing the tax-free status of the acquisition.

Issue (3)

Section 3.02 of Rev. Proc. 77-37, 1977-2 C.B. 568, 569, requires that there be at least a 50% continuity of interest, measured by the value of the stock received relative to the value of the stock surrendered, to obtain a private letter

ruling that a transaction qualifies as a reorganization under section 368 of the Code. However, section 2.03 of Rev. Proc. 77-37, 1977-2 C.B. at 569, provides that its 50% requirement for ruling purposes does "not define, as a matter of law, the lower limits of 'continuity of interest' . . . ."

As noted in the discussion of issue (1), the continuity of interest requirement is a judicially created standard. The stockholders of the acquired company must retain a "definite and material" interest representing "a substantial part of the value of the thing transferred." Minnesota Tea Co., 296 U.S. at 385. This standard involves questions of degree and does not prescribe any particular percentage of stock necessary to satisfy this requirement. Western Mass. Theatres v. Commissioner, 236 F.2d 186, 190 & 192 (1st Cir. 1956). In the final analysis, each case must rest upon its own facts. Miller v. Commissioner, 84 F.2d 415, 418 (6th Cir. 1936).

The Supreme Court has upheld tax-free reorganization treatment in a case having a continuity of interest lower than 50%. John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935), concluded that a reorganization does not require that a former target shareholder have a controlling interest in the acquiring company or participate in its management. The Court held that the receipt of nonvoting preferred stock was sufficient to confer on the former target shareholders "a definite and substantial interest in the affairs of the purchasing corporation . . . ." and that

the transaction was a qualifying reorganization. 296 U.S. at 377. This conclusion was based on the premise that an exchange for stock equal in value to approximately 38% of the value of the acquired corporation's stock represented sufficient continuity of interest in the acquiring company. Although there is no mention of this 38% figure in the Supreme Court's opinion, the case frequently is cited as an example of a qualifying reorganization involving a 38% continuity of interest. See, e.g., Paulsen v. Commissioner, 53 U.S.L.W. 4029, 4032 (1985 U.S.); Bittker ¶14.11, at 14-19; see also Rev. Rul. 61-156, 1961-2 C.B. 62, 64, considered in [redacted], G.C.M. 31698 & Supp., A-629467 (Jun. 24, 1960 & Mar. 9, 1961), which does not specifically mention the 38% figure, but states that there was less than a 50% continuity of interest in John A. Nelson Co.

Based on our resolution of issues (1) and (2), and using the calculations of the field agent in this case, there is approximately a [redacted]% continuity of interest in the [redacted] acquisition. This is comfortably above the 38% figure in John A. Nelson Co., and is within striking distance of the 50% test the Service uses for private letter ruling purposes.

Therefore, we conclude that there is sufficient continuity of proprietary interest in this case to satisfy the requirements for a qualifying reorganization.

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